

ARTICLES

AN ECONOMIC ANALYSIS OF THE VARIOUS RATIONALES FOR MAKING SHAREHOLDERS THE EXCLUSIVE BENEFICIARIES OF CORPORATE FIDUCIARY DUTIES

Jonathan R. Macey*

I. INTRODUCTION

Under traditional state and corporate law doctrine, officers and directors of both public and closely held firms owe fiduciary duties to shareholders and to shareholders alone. Directors and officers are legally required to manage a corporation for the exclusive benefit of its shareholders, and protection for other sorts of claimants exists only to the extent provided by contract. This legal norm, however, has been subjected to considerable stress as a result of recent legislative action in a majority of states that authorizes (or, in the case of one state, requires)¹ directors to take into account the interests of other "constituencies" such as employees, suppliers, customers, and the local community in making business decisions.²

This Article examines the three primary criticisms that have been levelled at the nonshareholder constituency statutes. The first criticism is that these statutes are unwise because they conflict with the underlying premise of corporate law that fiduciary duties should flow only to a firm's residual claimants. This argument is based on

* J. DuPratt White Professor of Law, Cornell University. A.B., Harvard University, 1977; J.D., Yale Law School, 1982. Professor Macey serves as Reporter to the ABA's Committee on Corporate Laws. The views expressed in this paper are Professor Macey's alone, and do not necessarily reflect the views of the Committee on Corporate Laws or the American Bar Association Section on Business Law.

1. CONN. GEN. STAT. § 33-313(e) (1991).

2. For a list of these statutes, see Symposium appendix, *infra* p. 279. The American Bar Association Committee on Corporate Laws decided not to include such a provision in the Revised Model Business Corporation Act. ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2253 (1990).

the idea that residual claimants have the greatest incentive to maximize corporate value and therefore place the highest value on the legal protection afforded by fiduciary duties. The conclusion that only residual claimants deserve the benefit of fiduciary duties does not logically follow from the premise that they are the group that places the highest value on the legal protection afforded by fiduciary duties. Specifically, this Article will show that, over a wide range of corporate decisions made by officers and directors, gap-filling responsibilities analogous to those provided by the fiduciary duties owed to shareholders are needed to protect nonshareholder constituencies such as workers, customers and suppliers.

Although the status of shareholders as residual claimants does not provide support for making them the exclusive beneficiary of managers' fiduciary obligations, nonetheless, for other reasons, fiduciary duties should flow to residual claimants, and to residual claimants alone. For one thing, the very nature of other claimants' interests makes it easier for them to protect against post-contractual opportunism by the firm. In addition, nonshareholder constituencies already enjoy the protection provided by judicial gap-filling and do not need the additional gap-filling protections afforded by fiduciary duties.

The second criticism levelled at nonshareholder constituency statutes is that they require corporate agents to serve so many masters — employees, communities, bondholders, customers, suppliers — that the costs of dual fiduciary duties in terms of confusion and misunderstanding by courts and litigants vastly outweigh any potential benefits that the statutes might provide. But this argument ignores the fact that corporations long have been able to issue multiple classes of shares with different economic and voting rights, with management owing fiduciary duties to each of these classes. Thus, it simply cannot be said that corporate law is incapable of reconciling the fiduciary claims of a variety of competing interests. The argument also ignores the effects of the business judgment rule. Because most managers' actions are effectively protected against judicial scrutiny anyway, as a practical matter, the rights being taken away from shareholders by nonshareholder constituency statutes do not provide much in the way of concrete benefits for shareholders in the first place.

Thus, the real problem with nonshareholder constituency statutes is not that they take away something of value from the only group that has any incentive to maximize the value of the firm, because other constituencies such as fixed claimants or workers often

have the greatest stake in the decisions being made. Similarly, non-shareholder constituency statutes cannot be condemned on the grounds that they upset a system of legal rules that present a preexisting set of clearly defined behavioral guidelines for officers and directors. No such set of guidelines exists.

It is the third criticism levelled at these statutes that presents the most compelling argument against them. This problem is that nonshareholder constituency statutes fail to recognize that fiduciary duties are owed to residual claimants and residual claimants alone because this is the group that faces the most severe set of contracting problems with respect to defining the nature and extent of the obligations owed to them by officers and directors.

Other constituencies besides shareholders face contracting problems, to be sure, but these problems can be solved at far less cost than those confronting shareholders. Thus, fiduciary duties should properly be seen as a method of gap-filling in incomplete contracts. And shareholders place a far greater value on the protection provided by this gap-filling than do the nonshareholder constituencies of a corporation.

This observation, of course, raises a follow-up question: If gap-filling is a useful device from the shareholders' perspective, why not from the perspective of nonshareholder constituencies as well? Here I argue that under modern principles of contract law, courts *do* fill in gaps for these other constituencies; but they do so against the background of the preexisting contracts that these groups have with the firm. Thus, gap-filling for employees or bondholders is done in the context of interpreting the employment contracts, collective bargaining agreements, bond indentures, and covenants that these other groups have with the corporation.

The obvious exception to this general rule arises with regard to the local communities in which large corporations operate. Unlike other constituencies, the local community has no preexisting agreement with the firm, leaving no gap for a court to fill. But the local community is, or should be, well represented in the political process. Any grievance felt by the community should be taken up with local political officials.

Finally, this paper considers — and rejects — the familiar (dare I say tiresome) argument that nonshareholder constituency statutes are worthwhile because they prevent inefficient wealth transfers from other constituencies, particularly bondholders and employees, to shareholders. The question is not whether such wealth transfers are

theoretically possible — clearly they are. Rather, the salient issues are: (1) whether the dangers associated with such wealth transfers can be avoided by contractually negotiated covenants between the fixed claimants and the firm; and (2) whether attempting to mitigate this wealth transfer problem through the promulgation of non-shareholder constituency statutes poses social costs that are greater than the social benefits. Here I argue that the problem of wealth transfers from fixed claimants such as bondholders and employees to shareholders can be dealt with by contract and that the costs to society of attempting to mitigate this wealth transfer problem through the promulgation of nonshareholder constituency statutes will be greater than any benefits that such statutes might provide. Indeed, it seems patently clear that the true purpose of these statutes is to benefit a single nonshareholder constituency, namely the top managers of publicly held corporation who want still another weapon in their arsenal of antitakeover protective devices. Like many other legislative initiatives, nonshareholder constituency statutes do not benefit the interests or groups that they ostensibly are intended to benefit.

II. THE THREE CRITICISMS OF NONSHAREHOLDER CONSTITUENCY STATUTES

A. The Residual Claimant Argument

The most well-known argument supporting the proposition that fiduciary duties should be owed exclusively to shareholders is derived from the insight of modern financial theory that shareholders retain the ultimate authority to control the corporation because they have the greatest stake in the outcome of corporate decisionmaking.³ The idea here is that, despite the fact that corporations are merely complex webs of contractual relations — and despite the fact that shareholders do not “own” the modern, publicly held firm in any meaningful sense — the ultimate right to guide the firm (or, more precisely, to have it guided on their behalf) is retained by the shareholders because they are the group that values it most highly.⁴

The implication is clear. Since shareholders value fiduciary duties most highly, they will *pay* other corporate constituencies for the right to have these duties inure to their benefit. If, for example, the

3. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 175.

4. *Id.*

shareholders place an aggregate value of \$10 million on the legal protection provided by a corporate governance system that allocates fiduciary duties exclusively to shareholders, while other constituents value it at \$2 million, then both parties will be better off if the shareholders are permitted to compensate these other constituencies — in the form of higher interest on bonds, higher wages to workers and managers, and better prices for suppliers and customers — for the right to have fiduciary duties flow exclusively to them.

Thus, *all* constituencies will be better off by allocating fiduciary duties within the firm exclusively to shareholders if the latter place the highest value on such duties. But why would shareholders, as residual claimants, place the highest value on fiduciary duties? After all, once we accept the view that the firm is not an entity at all, but a set of contracts or series of bargains, the organization decomposes

into a group of identifiable participants — e.g., investors, managers, creditors, employees, and suppliers — who negotiate an equilibrium position among themselves. An implication of this perspective is to deny that any one class of participants (i.e., the shareholders) have a natural right to view themselves as the owners of the firm. Rather, shareholders are seen not as the firm's owners, but as suppliers of equity capital; they are the "residual claimants," who bring to the firm their special ability at risk-bearing, which creditors, managers, and employees tend to lack.⁵

Of course, "[o]nce we view the shareholders as simply the residual claimants who have agreed to accept a more uncertain future return because of their superior risk-bearing capacity, it is far from self-evident that shareholders are necessarily entitled to control the firm,"⁶ i.e., to have managers' and directors' fiduciary duties flow exclusively to them.

The rationale for why shareholders place the highest value on such rights is said to be that:

Uniquely, the residual claimants . . . are interested in the firm's overall profitability, whereas creditors and managers [and presumably other constituents as well] are essentially fixed claimants who wish only to see their claims repaid and who will logically tend to resist risky activities. Having less interest in the overall [economic] performance of the firm, creditors can bargain through contract and

5. J. CHOPER, J. COFFEE & R. MORRIS, *CASES AND MATERIALS ON CORPORATIONS* 28-29 (3d ed. 1989) (footnote omitted).

6. *Id.* at 29.

do not need representation on the board to monitor all aspects of the firm's performance.⁷

Thus, fiduciary duties exist because the decisions that face officers and directors of corporations are sufficiently complex and difficult to predict that it would not be feasible to specify in advance how to respond to a wide range of future contingencies. Fiduciary duties are the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent contracts. These duties run solely to shareholders because, as residual claimants, "[t]he gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line."⁸ As Easterbrook and Fischel have observed:

As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion [or to have it exercised on their behalf].⁹

A simple example can be used to illustrate this point. Suppose that a firm has two classes of claimants, fixed and residual. The firm will owe \$1 million to the fixed claimants at the end of period one. Suppose further that the firm has to choose between two projects, "A" and "B." Both of these projects will require the firm to allocate 100% of its resources to that project for the relevant period. Project A has a 50% chance of producing a payoff with a present value of \$1 million and a 50% chance of producing a payoff with a present value of \$5 million at the end of period one. Thus, the expected present value of project A is \$3 million.¹⁰ Project B, on the other hand, has a payoff matrix in which there is a 50% chance of a payoff with a present value of \$1 million, and a 50% chance of a payoff with a present value of \$6 million. Thus, while project A has an expected value of \$3 million, project B has an expected value of \$3.5 million.

7. *Id.*

8. Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983).

9. *Id.*

10. $(.5 \times \$1,000,000) + (.5 \times \$5,000,000) = \$3,000,000$.

The shareholders will prefer project B, since they are better off by \$500,000 if they select that project.¹¹ The fixed claimants, by contrast, are indifferent as to whether the firm selects project A or project B, because under either outcome, the fixed claimants are absolutely certain to obtain the \$1 million that is owed to them by the firm. Where a firm is making a decision like this, the fixed claimants clearly do not deserve a role in the decisionmaking process. The firm and society are better off if the firm selects project B, because that is the project that maximizes the firm's and society's stock of wealth. No purpose is served by giving the firm's fixed claimants any stake in the decisionmaking process. The only possible result of their involvement would be to permit them to threaten obstruction of the firm's efforts to undertake project B in order to extract a side payment of some kind.

This example intuitively suggests that undivided fiduciary duties should flow to a firm's shareholders. Because this decision, like so many decisions made by corporations, is infra-marginal with respect to all constituencies other than shareholders, the shareholders should be the only parties with legal rights in the decisionmaking process. Further, as Easterbrook and Fischel suggest, the shareholders' position within the firm is unique because shareholders are the only group with a meaningful stake in *every* decision made by a solvent firm.¹²

But suppose that the decision was between project A as described above and a third project, "C." Project C has a 50% chance of producing a payoff at the end of period one with a present value of \$500,000 and a 50% chance of producing a payoff at the end of period one with a present value of \$10 million.

The shareholders would prefer project C to project A (or project B for that matter). Project C has an expected value of \$5.25 million,

11. Project A has an expected value to the shareholders of \$2 million. If the project only makes \$1 million, the fixed claimants will get all of the gains from the project, and there will be nothing left over for the shareholders. If the project makes \$5 million, the shareholders will get \$4 million because the first million goes to satisfy the firm's obligations to the fixed claimants. Thus, project A has an expected value to the shareholders of \$2 million ($.5 \times \$4,000,000 = \$2,000,000$).

Project B has an expected value to the shareholders of \$2.5 million. As before, if the project only makes \$1 million, the shareholders get nothing. If the project makes \$6 million, the shareholders will get \$5 million because the first million will go to the fixed claimants of the firm. Thus, project B has an expected value to the shareholders of \$2.5 million ($.5 \times \$5,000,000 = \$2,500,000$).

12. Easterbrook & Fischel, *supra* note 8, at 404.

yielding an expected return to shareholders of \$4.25 million. This compares favorably with project A's expected return to shareholders of \$2 million (after subtracting fixed claims), and project B's expected return to shareholders of \$2.5 million (after fixed claims). However, unlike the choice between projects A and B, the firm's fixed claimants are not indifferent with respect to the decision to select project C. Under project C, there is a 50% chance that the fixed claimants will be paid only half of the full \$1 million that is owed to them.

As such, fixed claimants would be willing to pay for the right to block project C; thus, it is simply incorrect to say that the shareholders are the only group with the correct incentives to decide whether to adopt project C or project A or B. Nor does society benefit by exclusively allocating fiduciary duties to the shareholders. It is possible to manipulate the numbers in the above examples — and the actual projects selected in the real world — to transfer wealth from the fixed claimants to the residual claimants while *reducing* rather than increasing the overall value of the firm. Imagine, for example, that the firm is selecting between two projects, "D" and "E." Project D presents a 50% chance of producing absolutely nothing and a 50% chance of producing a present value payoff of \$1.5 million at the end of period one. Project E presents a 100% chance of producing a present value payoff at the end of period one of \$1 million. Ex ante, the overall value of the firm is maximized by selecting project E, since that produces a present expected value of \$1 million, while project D produces a present expected value of only \$750,000. The shareholders, however, would prefer project D to project E, since under project E there is no chance that the shareholders will realize any payoff at all, while under project D there is a 50% chance that the shareholders will realize something, (i.e. \$500,000). Thus, if the shareholders are left in complete control, they will have incentives "to adopt various strategies with the effect of transferring wealth from bondholders to shareholders, such as choosing risky investment projects and withdrawing assets from the firm."¹³ As the above example suggests, some of the strategies that shareholders can adopt to transfer wealth from the fixed claimants and other constituencies to themselves reduce the value of the firm and reduce overall societal wealth as well.

Describing shareholders as residual claimants to the cash flow of

13. *Id.*

the modern corporation therefore does not completely explain why fiduciary duties flow exclusively to them. While the shareholders' status as residual claimants provides a persuasive rationale for why their interests should trump with respect to a wide range of transactions, it is also clearly the case that other claimants have a strong interest in participating, at least to some extent, in some of the decisions of the firm. Other claimants face the realistic prospect of tangible loss if decisions about how the firm's resources should be allocated are not made with their interests in mind.

Thus, the argument that shareholders, because they have the greatest incentive to maximize the value of the firm, should be the sole beneficiaries of the legal protection afforded by fiduciary duties is incomplete. It does not explain why the interests of other claimants should not be respected, at least as to those decisions that have the potential to affect their interests directly.

B. The "Too Many Masters" Argument

The second and perhaps the most common argument made against nonshareholder constituency statutes is that such statutes, to the extent they effect any change whatsoever in existing law, simply confuse the legal landscape by forcing directors to attempt an impossible task — pleasing a multitude of masters with competing and conflicting interests. As the Committee on Corporate Laws of the American Bar Association's Section on Business Law has argued in its position paper on nonshareholder constituency statutes:

The confusion of directors in trying to comply with such statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.¹⁴

In one view, the "too many masters argument" implies that non-

14. ABA Committee on Corporate Laws, *supra* note 2, at 2269.

shareholder constituency statutes make life more difficult for corporate managers and boards of directors. The better view is that such statutes simplify life for incumbent managers of the large, public corporation. After all, virtually *any* management decision, no matter how arbitrary, can be rationalized on the grounds that it benefits *some* constituency of the corporation.

Take, for example, the issue of whether a firm should relocate its headquarters from the large metropolis that has served as its base for many years to a small town with better schools, lower labor costs, and lower taxes. While shareholders might profit from this move, the community in which the firm is presently located would clearly suffer. Some employees might benefit, others might suffer. The firm could justify virtually any decision as serving the interests of some constituency. Imagine now that the proposal to relocate the company comes not from incumbent management, but from an outside bidder who is launching a hostile tender offer for the company at a substantial premium over the current market price of the firm's shares. Here the nonshareholder constituency statute can be used to justify resisting a lucrative offer that may be in the best interests of the shareholders.

Thus, the primary beneficiaries of nonshareholder constituency statutes are incumbent managers, who can justify virtually any decision they make on the grounds that it benefits *some* constituency of the firm. The benefits to the constituencies are, at best, weak. Strong support for this assertion lies in the fact that not only are these statutes (with a single exception)¹⁵ permissive, but they also do not afford standing to sue to any of the nonshareholder constituencies that they purportedly are designed to benefit.¹⁶ At the same time, they effect alarming changes in officer and director accountability to shareholders.

Dean Robert Clark expressed a similar sentiment, and observed that it is socially optimal for corporate law to single-mindedly promote the profit-maximizing interests of shareholders:

A single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests. . . . Assuming shareholders have some control mechanisms, better monitoring means

15. See *supra* note 1 and accompanying text.

16. Wallman, *Corporate Constituency Statutes: Placing the Corporation's Interests First*, BUS. LAW. UPDATE, Nov.-Dec. 1990, at 1,2.

that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do and do it efficiently.¹⁷

The “too many masters” argument does answer the question of why state legislatures have been so eager to enact these statutes. As one of their staunchest defenders has noted, nonshareholder constituency statutes were “[b]orn principally of last decade’s takeover battles.”¹⁸ Of course, the winners of the takeover battles of the 1980s were corporate shareholders, while the losers were incumbent managers. Nonshareholder constituency statutes give such managers the ability to obtain politically what they were unable to obtain in the marketplace — meaningful job security regardless of the quality of their performance.

But the “too many masters argument” is overstated. Corporations traditionally have been able to issue multiple classes of common and preferred stock. And corporate managers and directors have discharged fiduciary duties to all of these claimants simultaneously. Just as the interests of common shareholders can conflict with the interests of nonshareholder constituencies, so too can the interests of one class of equity claimants conflict with the interests of other classes. In particular, certain preferred shareholders may have interests that more closely resemble those of fixed claimants than those of common shareholders. Such preferred shareholders may prefer that a firm refrain from engaging in certain risky projects, while the common shareholders would prefer that the firm undertake such projects. Corporate boards have traditionally balanced the conflicting interests of such groups in a beneficial manner.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,¹⁹ the Delaware Supreme Court opined that it is permissible for a corporation to take the interests of nonshareholder constituencies into account, at least when there is no ongoing auction for the firm in progress.²⁰ In particular, a corporate board may take account of various corporate constituencies such as creditors, customers, employees, and the community generally when deciding how to proceed, so long as the action ultimately taken in the interests of these corporate groups meets the basic requirement that “there be some rationally related

17. R. CLARK, CORPORATE LAW 20 (1986).

18. Wallman, *supra* note 16, at 1.

19. 506 A.2d 173 (Del. 1986).

20. *Id.* at 176-82.

benefit accruing to the stockholders."²¹

In *Revlon*, the company was faced with a hostile takeover bid, and the firm's board of directors attempted to defeat the outside bid by entering into a lock-up agreement with a friendly suitor, ostensibly for the purpose of benefitting certain of the firm's fixed claimants. The Delaware Supreme Court found that, by the time Revlon entered into the lock-up, "a break-up of the company was inevitable."²² Once this was true, the directors' sole concern changed from being "defenders of the corporate bastion to auctioneers charged with getting the best price for shareholders"²³ Management was no longer permitted to take the interests of nonshareholder constituencies into account in deciding how to proceed. Other cases have reiterated that corporate managers may take the interests of nonshareholder constituencies into account, not only in their daily management of the firm, but also when deciding whether to accept or oppose an outside offer.²⁴

Two aspects of the Delaware Court's embrace of the nonshareholder constituency ideal deserve special attention. First, as the Committee on Corporate Laws has observed, in no case has the Delaware Supreme Court held that directors will be permitted to *prefer* the interests of other constituencies over shareholders. Nor has the court decreed that they *ought*, as a normative matter, to take such interests into account.²⁵ The Committee has reformulated the position of the Delaware Supreme Court to be that:

[D]irectors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders when so doing. In Delaware, this principle is modified when the decision is made to sell the company, at which time the directors may consider only the interests of shareholders.²⁶

Second, it is noteworthy that the Delaware approach to the nonshareholder constituency issue (like the argument made above concerning residual claimants) recognizes that, over a wide range of is-

21. *Id.* at 176.

22. *Id.* at 182.

23. *Id.*

24. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341-42 (Del. 1987).

25. ABA Committee on Corporate Laws, *supra* note 2, at 2260.

26. *Id.* at 2261.

sues, there really is no conflict between the interests of other constituencies and the interests of shareholders. Taking steps to improve worker morale is good for workers and good for shareholders. Taking steps to improve relations with the local community also has beneficial effect. Similarly, drafting strong bond covenants or cultivating a reputation for fair dealing with bondholders or other constituencies benefits the shareholders in the form of lower interest costs for debt and a lower cost of doing business generally.

Moreover, the Delaware approach recognizes the Hayekian argument that it generally is not possible to know with certainty which actions are in shareholders' interests and which are not.²⁷ Managers must be given plenty of latitude for experimentation. In addition, many technological or operational improvements that managers may make are at least as likely to come about as a result of pure happenstance and fortuity as they are of careful strategic planning. Consequently, judicial efforts to hold managers to a strict profit-maximization standard through the palliative of ex post review of corporate decisions is not likely to benefit anyone other than the legal community. The obvious exception to this general rule occurs where there is a palpable conflict of interest between the actions of managers and the interests of shareholders. Where this is the case, there is, of course, an important role to be played by judicial enforcement of corporate law norms.

To the extent that managers act in ways that are suboptimal from the shareholders' perspective, they will be disciplined, if at all, by the various markets in which such managers must operate.²⁸ Because of the problems of knowledge and uncertainty in the world of business, managers often act on the basis of custom, tradition, force of habit, by imitating the actions of more successful competitors, or as a consequence of a complex set of conflicting motivations. Courts are likely to be even worse than managers and directors at determining with absolute certainty which actions are in the best interests of

27. A basic tenet of Austrian economic thought, as exemplified by the work of Friedrich A. Hayek, is that "there is an inherent unpredictability and indeterminacy with regard to human preferences, expectations and knowledge." Kirzner, *On the Method of Austrian Economics*, in *THE FOUNDATIONS OF MODERN AUSTRIAN ECONOMICS* 40, 48 (E. Dolan, ed. 1976); see also F.A. HAYEK, *Economics and Knowledge*, in *INDIVIDUALISM AND ECONOMIC ORDER* 33 (1948).

28. These markets include the market for corporate control, the internal and external managerial labor markets, and the markets for the products offered by the firm. See Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 *DEL. J. CORP. L.* 540, 543 (1984).

shareholders and which are not. Allowing managers to take the interests of a variety of constituencies into account simply acknowledges that *ex post* second-guessing of managerial decisions probably does more harm than good. It is best for all parties concerned if courts decline to intrude on the internal process of corporate governance, except where such decisions are clearly motivated by self-interest.

To the extent that nonshareholder constituency statutes are interpreted in ways that are consistent with this general form of corporate law, they will be beneficial, not harmful. Consistent with the approach taken by the Delaware Supreme Court, the fact that such statutes give incumbent managers more freedom is only worrisome if managers can use that freedom in ways that are inconsistent with shareholder welfare.

The problem with nonshareholder constituency statutes is not that they require managers and directors to serve too many masters. The problem is that they have the potential to permit managers and directors to serve no one but themselves.

C. The Real Concern: Shareholders as the Group with the Most Acute Need for Fiduciary Duties

The real drawback of nonshareholder constituency statutes is that they fail to recognize that shareholders face more daunting contracting problems than other constituencies. These acute contracting problems vindicate the traditional common law rule that managers and directors owe their primary fiduciary responsibilities to shareholders. Nonshareholder constituencies can protect themselves against virtually any kind of managerial opportunism by retaining negative control over the firm's operations. Workers, bondholders, and even local communities can protect their interests by contracting for the right to veto future proposed actions by management. By contrast, the shareholders must retain positive control over the actions of the firm in order to realize the full potential value of their shares.

Merely because nonshareholder constituencies decline to contract for the right to veto certain transactions does not mean that they are unable to do so. Rather, the absence of contractual protection for nonshareholder constituencies may simply reflect the fact that such constituencies are unwilling to pay for such protection in the form of lower wages or lower interest rates on debt.

Workers are perhaps the group with whom one sympathizes the most when thinking about the possible benefits associated with nonshareholder constituency statutes. Unlike shareholders, who are con-

cerned with the overall profitability of the firm in which they have invested, workers are concerned with wages, pensions, hours, and working conditions. From a contracting perspective, wages and hours pose few, if any, contracting problems. Workers could potentially protect their wage expectations with pension guarantees, golden parachutes,²⁹ successor clauses, stipulated cost of living adjustments, and other straightforward provisions. Similarly, workers can obtain credible assurances against being forced to work undesirable hours simply by precisely stipulating the length of the work day. Working conditions can be guaranteed by making reference to a well-known status quo and requiring the employer to maintain working conditions at that level or above.

The point here is not to suggest that workers actually have the contracting power to protect their wages, hours, and working conditions. Rather, the point is simply that, unlike shareholders, it is at least technologically possible for workers to protect themselves by drafting strong contractual provisions in their favor. Moreover, should unforeseen contingencies arise that cast doubt on the efficacy of contractual protection, courts can protect workers by construing their employment contracts in light of the original purposes behind the agreements. Gap-filling by modern judges in interpreting contracts provides workers with the same sorts of protection that fiduciary duties provide for shareholders.

It might be argued that rank-and-file employees lack bargaining power, and that at-will employment contracts are likely to reflect this lack of bargaining power. Consequently, it has been argued that the gap-filling that is done in the context of at-will employment contracts is likely to be unhelpful to employees.

This argument is flawed and without merit. If workers lack bargaining power in their employment relationship, changing the law to add a fiduciary duty to this relationship will *harm* workers, not help them. This is because extending the reach of fiduciary duties to rank-and-file employees will not change any fundamental imbalance in the allocation of bargaining power between workers and their employers that already exists. Any legal regime that "protects" workers by making them the "beneficiaries" of fiduciary duties will, by definition, make those same workers less valuable (in monetary terms) to their employers. The employers will, in turn, utilize any bargaining power

29. These contracts typically provide a generous severance package in the event of a major corporate reorganization involving layoffs or shutdowns.

they possess to make the *employees* pay the full costs of these new legal obligations. Any employer unable to force her workers to pay these costs would not have unequal bargaining power in the first place.

Thus, if workers with little bargaining power being paid \$8.00 per hour were made the beneficiaries of a new set of fiduciary duties, their employers would simply respond to the additional costs of the new legal responsibilities associated with these duties by reducing the wages or benefits of those same workers by the amount of the additional costs. This is what it means to have unequal bargaining power.

Employers unable (due to minimum wage laws or other constraints) to reduce workers' wages or benefits simply will hire fewer workers. Thus, it is not possible to sustain the argument that imposing fiduciary duties will help workers who lack bargaining power; any lack of bargaining power on the part of the workers simply will manifest itself in some other way, such as in the form of a reduction in wages.

Since workers generally prefer to receive compensation in the form of cash wages rather than in other ways, even the workers themselves will prefer that fiduciary duties not be imposed on employers since such duties will, at the margin, result in lower cash compensation to workers for the reasons just explained.

The above arguments apply with even more force to bondholders.³⁰ First, bondholders can draft elaborately detailed contracts to protect themselves from transactions that upset the original understanding between themselves and the firm. For example, bond indentures often limit the ability of an issuer to borrow, merge, pay dividends, repurchase stock, issue preferred stock, sell assets, or engage in transactions with affiliate companies. While these provisions do little to protect shareholders (and indeed might be deleterious to their interests), they do much to protect bondholders and other fixed claimants against wealth transfers by other corporate interests.

Again, it is worth emphasizing that, for the purposes of the arguments presented in this paper, the issue is not whether bondholders have the bargaining power to obtain every contractual protection they desire when covenants and indentures are drafted. After all, bondholders, like other nonshareholder constituencies, are free to decline to invest in the firm if they are not satisfied with the risk/return

30. Smith & Warner, *On Financial Contracting, An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118-19 (1979).

trade-off being offered.

Instead, the relevant issue is whether it is technologically possible for the bondholders to protect themselves via contract. If it is, their only obstacle is *price*. Unlike shareholders, who must rely on the gap-filling protection afforded by fiduciary duties for assurance that a firm will maximize profits, bondholders can protect the present value of their fixed claims by drafting "put" provisions that give them the legal right to force the firm to repurchase the bonds at a predetermined price upon the occurrence of certain contingencies. Put provisions also have been drafted to require the firm to adjust the payments to fixed claimants so as to compensate them for such increased risks as higher leverage or downgrades in the firm's credit rating.

The put provisions accompanying bond sales generally are triggered by a merger or major restructuring, a change in the firm's ownership, a significant share repurchase, or similar transaction.³¹ Of course, it would be possible to draft even more complete protection for nonshareholder constituencies such as bondholders. The right to put the bonds back to the issuer might be triggered any time the market price of the bonds fell to a predetermined level in the open market. Such a provision would be easy to monitor and enforce and would provide virtually complete protection for bondholders against unforeseen contingencies. The issue, then, is not whether nonshareholder constituencies can protect themselves via contract, but whether they are willing to pay for such protection.

III. GAP-FILLING FOR NONSHAREHOLDER CONSTITUENCIES

The familiar retort to the preceding argument is that shareholders and the corporate managers who serve them are endlessly creative. As such, no matter how elaborate the guarantees, without the broad-based gap-filling provided by fiduciary duties, management's newly devised strategies will undermine whatever contractual protection nonshareholder constituencies negotiate.

An interesting variant on this argument has been made in an important article by Columbia University's Professor John Coffee.³² He

31. Winkler, *Harris, Williams Cos. Unit Are First to Offer Super 'Poison Puts'*, Wall St. J., Nov. 16, 1988, at s.3, p.1, c.3.

32. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986).

argues that the hostile takeover itself is best viewed as a shareholder strategy for reneging on the original bargain between nonshareholder constituencies (particularly managers) and the firm:

[T]he hostile takeover can be seen not simply as a mechanism that compels a management to accept that level of business risk that shareholders deem appropriate, but as a means by which shareholders outflank the safeguards managers obtained to protect the promises of deferred compensation and job security [that shareholders have given to managers]. Thus, what appears from the bidder's perspective to be a process of purging organizational slack looks from the manager's viewpoint more like deceptive reneging on the original understanding.³³

The ex post reneging argument seems flawed for two reasons. First, as noted above, nonshareholder constituencies can draft contracts that protect them against the consequences of future, unforeseen contingencies. Foreseeable contingencies such as hostile takeovers and corporate restructuring are even easier for nonshareholder constituencies to deal with contractually. Poison puts for bondholders and golden parachutes for workers have the potential to almost completely protect nonshareholder constituencies.

Second, it is inaccurate to suggest that absent nonshareholder constituency statutes, only shareholders enjoy the protection afforded by judicial gap-filling. An impressive body of literature indicates that modern judges should and do go a long way toward filling in unstated terms and conditions in long-term relational contracts³⁴ such as those forged between nonshareholder constituencies and public corporations. Modern courts examine the nature of the understanding between two contracting parties and interpret legal disputes between them in light of this understanding. Thus, nonshareholder constituencies (with the exception of local communities) already enjoy substantial gap-filling protection.

To be sure, there have been notable cases in which nonshareholder constituencies have sued to vindicate implied contract terms and have lost.³⁵ But such cases only illustrate that, ex post, all parties have an incentive to urge courts to interpret contracts in the

33. *Id.* at 24.

34. See Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

35. See, for example, the suit brought by bondholders of RJR Nabisco challenging the \$25 billion leveraged buyout of that firm. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989).

way that suits their interests. Courts must sift through competing arguments to obtain the result most consistent with the parties' original understanding.

For nonshareholder constituencies, the starting point for this judicial gap-filling process must be the contract itself. It may be an employment agreement, a collective bargaining agreement, a bond indenture, or a standard form contract between a firm and its suppliers or customers. For shareholders, it is widely recognized³⁶ that the "contract" they enter establishes that managers have a duty "to make corporate decisions so as to maximize the value of [their] shares"³⁷ Fiduciary duties are a corporate governance device uniquely crafted to fill in the massive gap in this open-ended bargain between shareholders and corporate officers and directors.

Recent attempts to expand the scope of managements' fiduciary duties to nonshareholder constituencies are therefore misguided for two reasons that have previously gone unrecognized. First, to the extent that such duties are legally enforceable, they shift the focal point of the analysis of the relationship away from the actual contract between the relevant constituency and the firm. Allocating fiduciary obligations to nonshareholder constituencies takes the judicial gap-filling process out of its proper framework, depriving judges of any coherent basis for allocating rights and responsibilities within the firm.

Inevitably, removing the gap-filling done by judges for nonshareholder constituencies from a contractual framework and placing it in a fiduciary duty framework creates potential conflicts between the express and implied terms of the actual bargains that such nonshareholder constituencies have struck with the firm and the new "rights" being created by nonshareholder constituency statutes. To the extent that these new rights are allowed to trump the terms contained in a contract between a nonshareholder constituency and the firm, such statutes simply transfer wealth from shareholders to these other constituencies. The specter of such wealth transfers diminishes incentives to invest in public corporations, impedes capital formation, and reduces societal wealth generally.

36. Macey, *supra* note 3, at 186.

37. R. CLARK, *supra* note 17, at 17-18.

IV. THE LOCAL COMMUNITY

Local communities constitute a possible exception to the above analysis because, unlike nonshareholder constituencies, they may have no preexisting contractual relationship with the firm that can provide the basis for reconstructing the original understanding between the parties in the event of future conflict. Of course, a local community will often negotiate to provide certain services and infrastructure support in exchange for a decision by the firm to locate in that community. In such cases, adding fiduciary duties to the local community on top of the express contracts between the firm and the community will only hinder the ultimate resolution of future disputes.

But often there will be no express or implied understanding between a firm and its community.³⁸ Where there is no agreement, creating an amorphous, open-ended fiduciary duty to the local community in which the firm operates is impractical.

Creating such a duty transforms the top managers of public companies from private businessmen into unelected and unaccountable public servants. A decision to elevate the interests of a local community above the interests of a firm's shareholders is nothing less than a decision about how to allocate wealth within society. Further, there seems to be a broad consensus that "the reallocation of wealth is a function for which directors are not especially suited and one beyond the general pale of their perceived mandate from society."³⁹

Expanding the scope of a firm's fiduciary duties to include local communities, as with other nonshareholder constituencies, is unnecessary. Local communities have unique access to the political process. If actions of a firm are genuinely detrimental to a local community, the members of that community can appeal to their elected representatives in state and local government for redress. Under either a pluralist or a republican understanding of governmental process,⁴⁰ local communities should be able to mobilize into an effective political

38. See Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 618 (1988) (describing the disruptions caused to the community of Youngstown, Ohio when the United States Steel Company closed two plants there).

39. ABA Committee on Corporate Laws, *supra* note 2, at 2270; see also Note, *Takeover Dangers and Non-Shareholders: Who Should Be Our Brothers' Keeper?*, 1988 COLUM. BUS. L. REV. 301.

40. For a republican perspective on government, see Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539 (1988). For a pluralist critique, see Macey, *The Missing Element in the Republican Revival*, 97 YALE L.J. 1673 (1988).

coalition to press for protection from harmful actions by corporations. The better argument seems to be that corporations need protection from local communities' abuse of the political process at least as much as local communities need protection from opportunistic corporate behavior. The political capital generated by local politicians over the strike at the *New York Daily News* illustrates this point nicely.⁴¹ Politicians have been falling all over themselves to demonstrate solidarity with the striking *Daily News* employees, with little or no regard for the substantive merits of the dispute.

The Worker Adjustment and Retraining Notification Act⁴² shows that local communities can protect themselves in the political process and hardly need any additional protection that might be afforded by a plant closing law. The Act requires that, under virtually all conditions, firms with one hundred or more employees give workers and communities sixty days notice prior to closing a plant. The Act requires that workers be paid for every day that they are deprived of notice.⁴³

CONCLUSION

The argument that the fiduciary duties of officers and directors in public corporations should run exclusively to shareholders and not to other constituencies is an uneasy one. As shown above, the shareholders' unique status as residual claimants provides a persuasive rationale for allocating fiduciary duties to shareholders in some, but by no means all, situations. In simple terms, where nonshareholder constituencies have no meaningful stake in a particular decision, they have no constructive role to play in the decisionmaking process. Including them in such decisions would lead to opportunism and a diminution in societal wealth. On the other hand, nonshareholder constituencies plainly have a meaningful stake in a wide range of decisions. Thus, the special role of shareholders as residual claimants does not completely explain why shareholders should be the sole beneficiaries of corporate fiduciary duties.

I have stressed that the fiduciary duty owed to shareholders is a

41. See, e.g., *Stars Meet Press at News-Aid*, *Newsday*, Dec. 15, 1990, at 6 (city ed.).

42. 29 U.S.C. §§ 2101-2109 (1988).

43. *Id.* § 2104(a). The statute provides exceptions for businesses struck by unforeseen circumstances and businesses in dire financial straits. *Id.* § 2102(b)(2). For further background on this provision, see Wehr, *Reagan Bows to Politics on Plant Closing Bill*, 46 CONG. Q. WKLY. REP. 2216, 2216 (1988).

device that fills in the implied terms of the contract existing between shareholders and the firm. This contract requires officers and directors of corporations to maximize overall firm value for shareholders. The fiduciary duty owed to shareholders is the only gap-filling device available to protect shareholders' investments. By contrast, other claimants enjoy the gap-filling that courts routinely supply when interpreting the terms of their contracts with the firm. Thus, allocating a fiduciary duty to shareholders does not really give shareholders a level of protection not enjoyed by nonshareholder constituencies. Instead, the fiduciary duty owed to shareholders simply provides the residual claimants with a level of judicial protection commensurate with the nature of the firm's contractual obligations to them.

Ironically, the ostensible reason for enactment of nonshareholder constituency statutes is to provide such nonshareholder constituents with the enhanced legal protections that shareholders enjoy. In fact, in light of the pervasive conflicts of interest that exist between shareholders and managers, it seems clear that if any group within the firm is in need of additional legal protection it is the shareholders. Instead, the recent wave of nonshareholder constituency statutes gives undesirable leeway to incumbent management to rationalize dubious or arbitrary corporate strategies that reduce the overall value of the firm on the suspect grounds that some nonshareholder constituency will benefit.